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A Political Economy Analysis of South Asian Integration: A Case of South Asia Association for Regional Cooperation Is Regional Cooperation in South Asia Viable?

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Ⅰ. Introduction

The issue of the integration of Turkey to the European Union (EU) has put economic integration at the front of the topics that have received most attention from academia, be it from economists or political scientists, as well as from regular press. The attention proves that there is still a global trend and desire of economic integration, and it is interesting to see how much further EU can advance in terms of integration. EU became a role model for integration to ambitious people including South Asian leaders.

South Asia is one of the most problematic regions in the world, with the issues of poverty, nuclear conflicts between India and Pakistan, terrorism, religious conflicts, etc. However, EU has shed light on this region to improve such problems. International trade is more and more assimilated to trading between integrated blocks than between countries as it was the case some fifty years ago. Several organizations of regional integration have seen life, among which is the South Asian Association for Regional Cooperation, (SAARC), the focus of this paper. The SAARC as envisioned by its founders was a response to the global trend of integration as well as more prosperity for the region.

This paper is going to explore where the SAARC would go, by analyzing both economic and political perspectives. The paper argues that the SAARC is going to be strengthened, and that the regional integration in South Asia will eventually advance from only a free trade area to common markets at least. It is still too difficult and too soon to forecast the possibility of monetary union. From the economic perspective, regional integration in South Asia seems more hopeful than from the political perspective. South Asian countries will greatly benefit if they

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eliminate most of the trade barriers among themselves. From the political perspective, it may be more difficult to see if the integration will be beneficial because of regional conflicts between India and Pakistan, for example. However, there is a sign of improvement of relations between India and Pakistan in recent years, due to the U. S. support and a common enemy of terrorism.

Ⅱ. Theories of Economic Regional Integration

a. Economic Perspectives;

Economic theories suggest that economic integration leads the member countries to prosperity and peace. Economic integration allows member countries to economically act as one country with a bigger domestic market and protect such a domestic market with tariffs on imports from outside of the group. The success of economic integration depends on the degrees of trade creation and trade diversion. "Trade creation is the net volume of new trade created by forming the trade bloc." "Trade diversion is the net volume of trade diverted from low-cost outside exporters to higher-cost bloc partner exporters." (Pugel, 2004) The size of social welfare determines whether or not the integration is successful and beneficial to the society or not, from the economic perspective. When trade diversion dominates, the effect brings a net loss of social welfare to the member countries. When trade creation dominates, the effect brings a net gain to them. The difference between these two effects determines the social welfare for a member country.

Among possible gains from economic integration, the theory of trade blocs also suggests that 1) competitive trade can lower prices, 2) it can also lower costs of production, 3) firms have more opportunities for their businesses in the bigger market by using scale of economy, and 4) member countries have opportunities to receive more foreign direct investment (FDI). FDI plays an important role for development. The more FDI, the more growth. FDI leads to more production and can bring up GDP indirectly.

b. Power Transition;

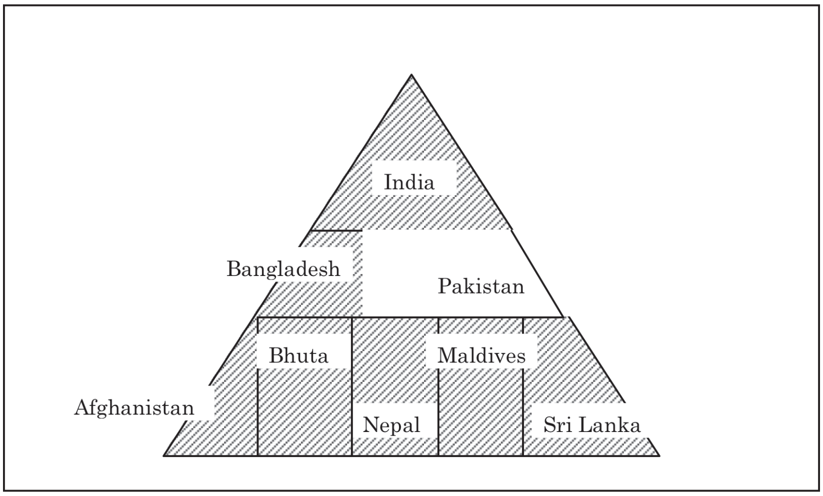
Economic and political integration among status quo nations, or nations satisfied with the status quo, is supported by Power Transition theory, as well. (Ronald L. Tammen et al., 2000). The theory maintains that such integration leads status quo nations to stability while challengers, or nations dissatisfied with the status quo, make the status quo to either stability or instability, depending on the regional dominant nation and the challengers approaching one another cooperatively or non-cooperatively. The theory suggests that such integration brings joint benefits in the long run among the status quo nations by means of cooperation.

Economic gains accumulated by major powers supporting the dominant nations strengthen the support for the status quo. On the other hand, if challengers cooperate with other challengers against the dominant nation, the status quo may be threatened or even overturned.

The key to peace is to keep power imbalance. India is more powerful than Pakistan, peace and regional stability are ensured, as long as Pakistan does not form an alliance with other great powers such as China or the United States. If challengers are growing or ganging up with other dissatisfied nations, it is a serious problem to the status quo nations To prevent that, a regional hegemon must try to keep its preponderance by getting together with more satisfied countries and converting dissatisfied nations to satisfied nations. This can be achieved through integration. In fact, all the nations but Pakistan in South Asia are satisfied nations, following India's preponderance, although Bangladesh could turn to the Pakistani side due to the same religion, Muslim.

The Figure below shows the power pyramid of South Asia. India is on top, and Pakistan and Bangladesh have more power than the rest of the nations. Even if Pakistan and Bangladesh are combined together, they cannot compete against India economically and politically. This far, India seems to be taking the right approach from Power Transition theory perspective.

According to Power Transition theory, a war would most likely occur when the challenger's relative power to the dominant nation reaches 80% of the dominant nation's power, in order for the challenger to overtake the dominance. In South Asia, Pakistan is far from that point. No one else is there to threaten India. In addition, Pakistan is a nuclear-capable nation, with medium-range missiles. According to Power Transition theory, nuclear deterrence functions most likely.



c. Previous Analyses of Economic Integration of South Asia;

Economic theories suggest that removing trade barriers will increase trade volume and hence GDP. Panagariya (2003), however, argues that the preferential trading liberalization is a mistake, especially to India, because 1) there is low intra-trade dependency within the region, 2) there is a significant volume of informal intra-trade, and 3) there is no theoretical support for the success of economic integration if the member countries have low level of intra trade before the countries form the economic bloc.

Bandara and McGillivray (1998) argue that it was successful for South Asian countries to adopt some of East Asia's export-oriented trade policies in improving their growth rates. However, South Asia will have much better results if it keeps improving its trade policies. Pohit and Taneja (2003) argues that informal trade, or illegal trade including trade of illegal drugs and trade with illegal avoidance of tariffs, hurts economy between Bangladesh and India. Hassan (2001) argues that SAPTA helped economic improvement of South Asia and that SAFTA will be more helpful. All these authors, including Panagariya, suggest that South Asia will improve its economic situation by increasing trade with the member countries of SAARC through SAFTA, as long as the members reduce trade and non-trade barriers, for example, by enhancing their trade facilities such as port, lowering tariffs, eliminating quotas.

Ⅲ. Background

a. South Asia

Figure 1 shows the areas, GDP, population, GDP per capita and human development of South Asian counties. India is the biggest nation among them in area, GDP, and population. Maldives has the highest GDP per capita, while India is the number three from the top in GDP per capita due to its large population. The total population of India, Pakistan, Nepal, Bangladesh and Sri Lanka takes 21.5% of the world population, which is even more than China's population. However, the total GDP of these 5 countries is approximately 1.5% of the world GDP, and is less than 60% of China's GDP. Closely looking at the GDP of South Asian countries, Pakistan's GDP is approximately one-fifth of India's GDP; Bangladesh one-tenth; Sri Lanka one-twentieth; and Nepal one-hundredth. This shows that India is the regional super power. Human development indexes are quite low in South Asia, except Sri Lanka and Maldives. All the South Asian countries have 30%-40% of population under absolute poverty line. (Esho, 2000) The poverty issue is quite serious and significant in this region. After all, South Asia is one of the poorest areas in the world.

Figure 1: Basic Information of South Asia

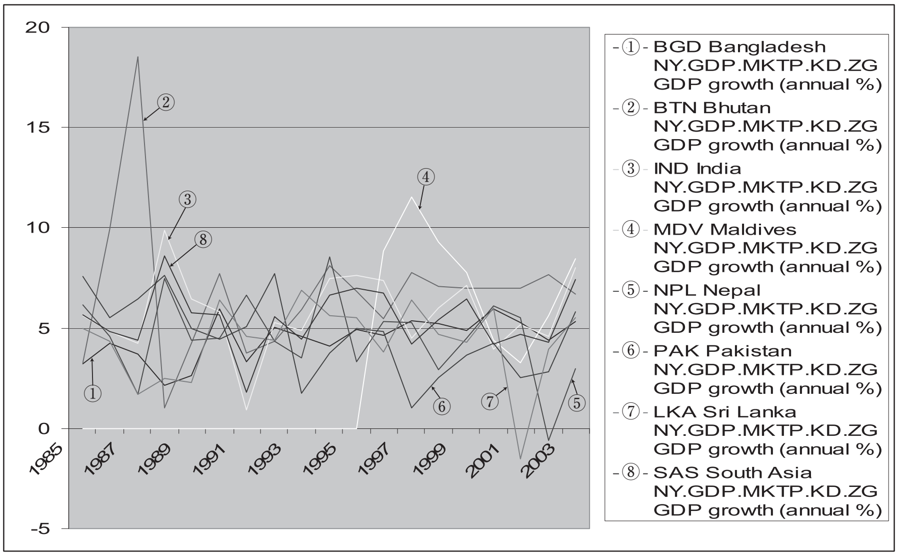
	Area (sq. mile)	GDP (USD mill.) 2000	Population (mil.) 2001	GDP per capita (PPP, USD) 2000	HDI Value
Bangladesh	56,977	47,106	140.37	1,602	0.478
Bhutan	18,150	482*	2.09*	1,412	0.494
India	4,222,243	456,970	1,017.54	2,358	0.577
Maldives	115	561*	0.28	4,485	0.743
Nepal	53,827	5,497	23.59	1,327	0.490
Pakistan	307,374	61,638	144.97	1,928	0.499
Sri Lanka	25,332	6,305	19.10	3,530	0.741
SAARC	1,684,014	578,559	1,347.94	...	...

Source: For the first column: *The World Almanac and Books of Facts 1998*; for the second column, GDP at producer prices, using the average exchange rate from the IMF, as reported in *World Development Indicators 2002*; "*" indicates author's own calculations from *International Financial Statistics*, using GDP (IFS code 99b), and average exchange rate vis-à-vis the USD (IFS code rf); for the third column, population (IFS code 99z) from *IFS Yearbook 2002*; the values for GDP per capita for purchasing power parity (PPP) in 2000 and Human Development Index (HDI) are taken from *Human Development Report 2002*.

As of 1960, GDPs per capita in purchasing power parity (PPP) of South Asian countries were almost at the same level as South Korea. Sri Lanka's GDP was twice as big as that of Korea back then. However, GDPs per capita of South Asian countries have dropped to 12%-28% to Korea's GDP in 1995. (Esho, 2000) There are many reasons that explain this phenomenon. Among them is education since Korea has higher literacy rates than South Asian countries. This indicates that there are many unskilled labors in South Asia.

Figure 2 shows the economic growth rates of SAARC countries from 1985 to 2003. The paths of the growth rates are not upward slope; rather, they have business cycles with sharp up-downs. Bhutan recorded the highest growth rate 18% in the figure. This was the time when Bhutan started to intensively export of horticulture and fruits. Sri Lanka recorded the lowest growth rate in 2002. This was negative growth, which was caused by shortage of energy. Sri Lanka could not operate factories. The average growth rates are approximately 5% from 1985 to 2003. This is not as good as other developing countries such as South Korea and China.

Figure 2. Growth Rates of South Asian Countries



Source: *World Development Indicators Online 2004*

Let's take a look at other macroeconomic indicators. The growth of the agricultural and especially industrial sectors has dramatically dropped in the last few decades in South Asia, which has caused the difference in growth between South Asia and Korea.

Looking at the domestic savings rates and investment rates, South Asian countries except India have quite low rates. For example, the savings rates of the Association of South East Asian Nations (ASEAN) countries are more than 35% for savings rates to GDP, while India's is 22% in 2000. (*World Development Indicator, 2004*) Without great improvement of technology, India will not be able to reach the grow rates as high as ASEAN countries.

As for inflation rates, all the South Asian countries have quite low rates, up to 10%. Compared to Latin America with former hyper-inflation rates, 10% is quite low. This suggests that Latin American countries depend on their revenues from signorage, printing money, while South Asian countries do not. Interestingly, South Asia has low inflation and low growth. However, the ratios of budget deficit to GDP are quite high in South Asia, which indicates that they have a tendency of inflational budgets. (Esho 2000)

Now looking at the aspect of trades of goods and services, the ratios of trade to GDP have dramatically increased in Bangladesh, India, and Pakistan since the SAARC was established in 1985. Although their trade ratios doubled, they are still at the low level, compared to other export-oriented countries such as Korea.

All South Asian countries run trade and current account deficits. Among them, Bangladesh and Sri Lanka have significant trade deficits, while Pakistan and Sri Lanka have huge current account deficits. These phenomena are partially caused by the trade propensity. South Asian countries mainly export primary goods such as diamond polish, cotton, clothes, and tea. Their exporting goods do not have much added value, and low technology and low productivity causes inefficient production, which put them in such deficits.

As for FDI, India increased the pace of trade liberalization in 1991, which induced US$ 1,750 million in 1995. (Esho 2000) Other South Asian nations also recorded great increase in FDI.

The exchange rates seem quite stable, although India devalued its currency a few times in the past. The neighbor countries adjusted the value of their currency accordingly without a big fuss. This is because their economic activities are so trivial on the scale of international trade that India's devaluation did not seem to have a great impact on the international trade arena.

The SAARC adopted South Asian Preferential Trade Agreement (SAPTA) in 1995. The SAPTA purposes the promotion of intra-trade by lowering tariffs. Each member country has set preferential tariff goods. There are 106 preferential tariff goods for India; 35 for Pakistan; 31 for Sri Lanka; 17 for Maldives; 14 for Nepal; 12 for Bangladesh; and 7 for Bhutan. Since their exporting goods are similar, however, SAPTA is not effectively functioning. There is not much of trade between Pakistan and Nepal; and Nepal and Sri Lanka. This indicates that the relations among member countries are quite bilateral with India, and they lack of horizontal networking between other countries rather than India. India plays a dynamic role in the region both economically and politically. Interestingly, not to mention that India is economically the center of the region, India is geographically located in the center of the region, as if India were a planet and the other nations are satellites. India shares its borders with all other member countries, while the other members do not.

In order to enhance the progress of economic integration, the SAARC countries also agreed to start South Asian Free Trade Area in 2006.

b. Stages of Regional Integration

There are 5 steps for regional integration: 1) free trade area, 2) customs union, 3) common market, 4) economic and monetary union, and 5) political union. The first four steps are economic theories of integration, and the last one is included in a political theory.

The very first step of regional integration is to form a free trade area. This can be bilateral or multilateral in the first stage. Governments of nations in the same region make such an agreement that member countries remove trade barriers such as tariffs on imports among themselves but maintain trade barriers against the outside of the group. The second step of the integration is custom union. The essential features for this step is that the member nations agree with customs regulations, usually eliminating or lowering tariffs on imports and other trade barriers for the member countries as well as adopting common external tariffs on imports from the rest of the world. The third step is common market. Without such trade barriers, the markets in the region function as if they were a large domestic market. This stage includes the features of free trade agreements and a customs union, as well as free factor mobility of capital and labor among the member countries. The fourth step is monetary union. At this stage, the member countries adopt one single currency, losing monetary authority – i.e., the governments of the member countries lose their capability of monetary policy-. A good example is that the European Union has adopted the euro. Its monetary policy is made by its central bank, the European Monetary Union (EMU).

Ⅳ. Problems and Progress;

The main problems in this region from the economic perspectives are:

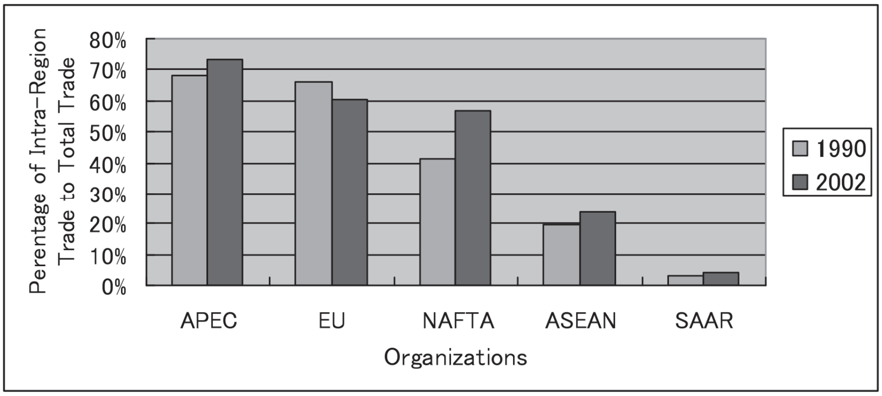
1) Low intra-trade
2) High tariff
3) Dependency of tariff for revenue
4) High transaction costs
5) Informal trade
6) Low quality of infrastructure
7) Low FDI
8) Against TWO rules

None of these above showed dramatic improvement although there is some improvement, which lead the SAARC countries to a better economic situation. However, there is still great potential for the SAARC to enhance the problems above and achieve greater economic success. The details will be discussed in the data analysis section of this paper

Ⅴ. Data Analysis;

Figure 3 shows intra trade as a percent of total region export. As you see the figure, the SAARC has very low intra regional trade, compared to other regional organizations. This indicates that the export goods of SAARC countries are quite identical, which means that their export competitive but not complementary goods. Their main products are primary goods and small-value added primary goods such as garments. However, the intra trade increased from

Figure 3: Intra-Region Trade as a Percent of Total Regional Trade



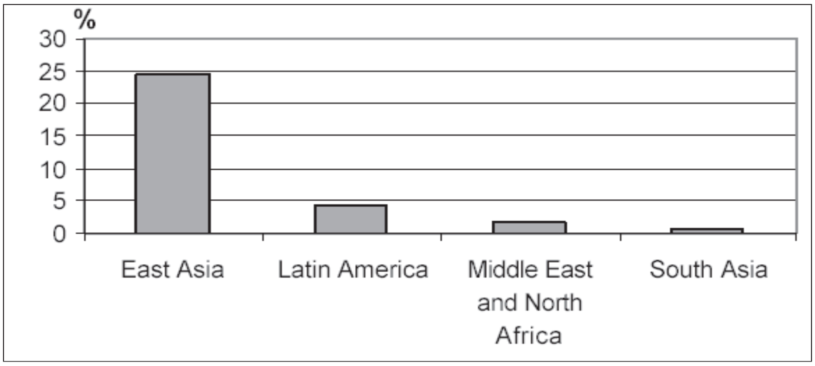
Source: "South Asia Regional Integration: India Country Note, South Asia Regional Economic Cooperation: Private Sector Perspectives." The World Bank/International Monetary Fund 2004 Annual Meetings. *World Development Indicators*, 2004

1990 to 2002 by 1%. This is partly because the SAPTA started in 1995. This increase indicates that the trade creation effect was higher than the trade diversion effect, which is a hope for further integration since the social welfare of the member countries increases when the trade creation effect dominates the trade diversion effect.

Another interesting finding from the figure is that even though Asia and Pacific Economic Cooperation (APEC) has the highest intra-regional trade among the organizations listed in the figure, it is not nearly close to the first step of economic integration, a free trade area. This is because the two main member countries, the United States and Japan, have been against it. For example, the United States does not want Japan to export more high tech electronics products to the United States; Japan wants to protect its agricultural sector. Thus, the more intra-region trade does not necessarily mean more possibility of economic integration. Since SAARC has such low ratios of intra-trade, it has a plenty of room to improve intra-trade.

Figure 4 shows the intra-regional trade integration of 4 developing regions in the world: East Asia, Latin America, Middle East and North Africa, and South Asia. South Asia has the lowest intra-regional trade integration. This figure again indicates that Latin America, Middle East and North Africa, and South Asia export primary products such as natural resources and agricultural products. They mainly export their goods to other regions like the United States that need such products. On the other hand, the high intra-regional trade of East Asia indicates that its value added products are complementary, rather than competitive.

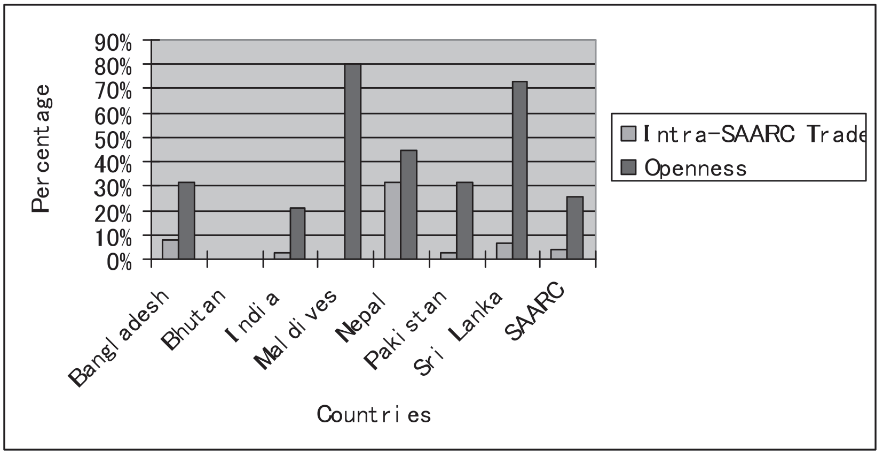
Figure 4: Intra-Regional Trade Integration（Intra-regional trade as a share of GDP in 2002）



Source: United *Nations COMTRADE data and World Development Indicators*

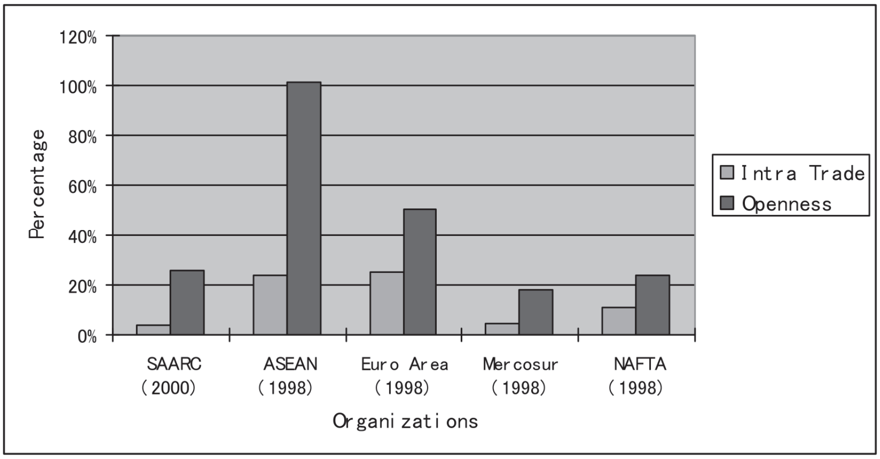
Figure 5-1 shows intra-SAARC trade and trade openness. Although their intra-regional trade is quite low, their trade openness is not very low. Maldives' openness is nearly 80%, and Sri Lanka's is 73%. This is probably because Maldives depends on tourism for its economy, and foreign tourists directly spend in Maldives. Sri Lanka has traditionally been trading primary products with other nations. Nepal has high intra-trade because Nepal has a bilateral trade agreement with India. Nepal exports energy created by hydro power plants to India.

Figure 5-1: Regional Trade Patterns 1



Sources: Intra-SAARC trade from *Direction of Trade Statistics Yearbook 2001*. Openness from *International Financial Statistics (IFS) 2001*.

Figure 5-2: Regional Trade Patterns 2

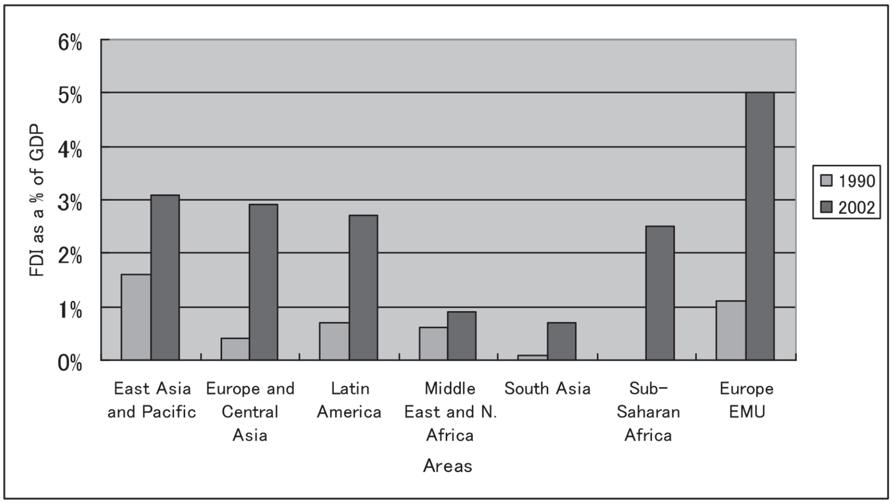


Sources: *International Financial Statistics (IFS)*

Figure 5-2 shows the same of different regional organizations. SAARC's openness is quite parallel to other regions. The reason that North American Free Trade Agreement (NAFTA) has low openness is probably because the United States and Canada have high volume of trade, which is just like one big nation. ASEAN has high openness probably because they it borrows foreign money or it has not paid after purchases.

Figure 6 shows FDI as a percent of GDP. Again, South Asia recorded very low percentage of FDI inflow. One of the reasons for it is that a large amount of FDI cannot come in to such a small size of economy. Also, physical infrastructure such as transportation, as well as soft infrastructure such as business and financial regulations, are not well established, which makes it more difficult for foreign investors to invest. However, partly due to SAPTA, South Asia has gained some confidence from foreign investors, and FDI has increased by 7 times in 12 years.

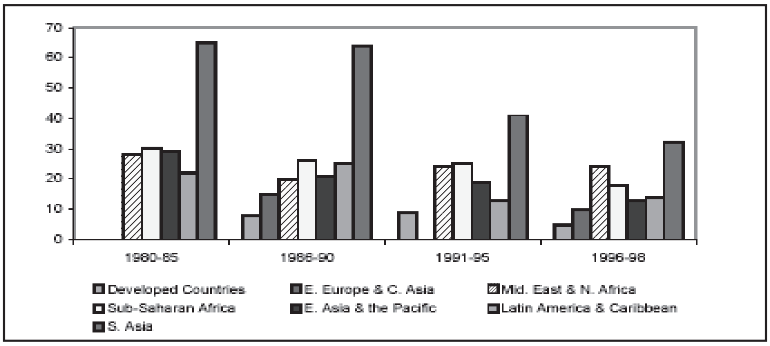
Figure 6: FDI as a precent of GDP



Source: *World Development Indicators Online 2004*

Figure 7 shows simple average of regional import tariff rates. The SAARC has outstandingly high tariff rates, compared to other regions. This indicates closeness of trade. These high tariff rates have frustrated especially intra-region trade. This is probably because the SAARC members have competitive exporting goods, so that if they lower the tariffs, primary products will gush in from neighbor countries and hurt domestic producers of those primary products. It might have been a domestic political reason that the SAARC countries could not lower the tariffs.

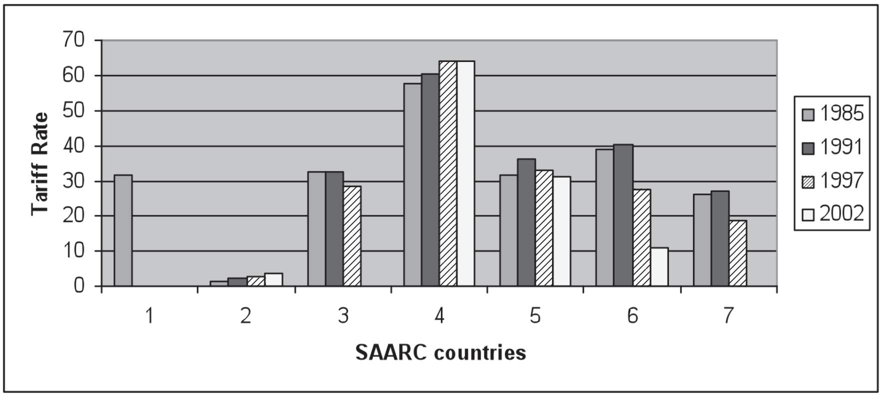
Figure 7: Simple Average of Regional Import Tariff Rates (percent)



Source: Bandara (2003). "How Desirable is the South Asian Free Trade Area?: A Quantitative Economic Assessment." *The World Bank*.

Figure 8 shows tariff as a percent of total revenue. This indicates that all the SAARC countries except Bhutan depend heavily on tariffs for their total revenues. Unlike many Latin American countries, the SAARC countries did not depend on signorage for their revenues. By over-printing money, Latin American countries have suffered hyper-inflation. It is understandable why the SAARC countries did not have such hyper-inflation. This makes it more difficult for the governments of the countries to lower their tariff rates unless they assure other sources of revenue. As is often the case with developing countries, many areas of the SAARC countries are not developed, and it is difficult for the government to collect income and business taxes, which is a big part of revenue for developed countries. As a side-effect of high tariffs, informal trade often takes place in this region, in order to avoid paying the tariff. This effect reduces the government revenues.

Figure 8: Tariff as a percent of Total Revenue



Note: 1 Bangladesh; 2 Bhutan; 3 India; 4 Maldives; 5 Nepal; 6 Pakistan; 7 Sri Lanka
Source: *World Development Indicators (Online), 2004*

Ⅵ. Conclusion

SAFTA should minimize the trade diversion effect and maximize the trade creation effect, in order to gain greater social welfare within the SAARC. Intra-trade increased only by 1%. This suggests the trade creation effect barely surpassed the trade diversion effect. To assure tax revenues, the SAARC needs to establish better institutions that make sure to enforce tax regulations. This way, the SAARC will not have to depend on tariffs as revenue.

Infrastructure needs to be better established. Several World Bank reports pointed out that the port facilities need to be renovated and that import processes need to be simplified with less paper work. Improved port facilities and systems will reduce vessel delays; lead to lower shipping costs; and then make it easier to use larger and more economic vessels. Such better shipping services that attract more trade. These reforms can make imports more efficient and hence lower transaction costs.

Gains from integration include expansion of goods and services and increase in FDI. Benefits from trade expansion includes potential intra-trade increase from US$0.5 bill to 2 billion. Economic integration can boost FDI, as we saw from the EU and NAFTA's experiences. FDI can boost economic growth even faster. Furthermore, economic integration induces greater trade diversification. There is not much intra-trade in this region, so that by increasing intra-trade, South Asia can diversify its trade tendency. Finally, switching from informal trade to formal trade will increase consumer welfare, reduce efficiency losses. Many goods from India to Pakistan goes through Dubai, which causes extra transaction costs.

From the economic perspectives, the SAARC can advance to at least third step of economic integration, common market. Feng and Genna (2003) argued that homogeneity of domestic economic institutions for economic union. In South Asia, there is much diversity in races, languages, religions, population size, ethnicity, the size of GDP, growth rates, cultural backgrounds etc., which makes it difficult for them to create homogeneity of domestic economic institutions. Besides, the SAARC countries have not started a free trade area yet. Therefore, it is still too soon to discuss or forecast the possibility of economic union. However, as Feng and Genna (2003) also argued that the process of regional integration reinforces each other, the process will relatively easily lead the SAARC countries to the second and the third step of integration: customs union and common market. One of the reasons of optimism about economic integration is that the private sector is more enthusiastic about integration. With the support of people, economic integration seems plausible.

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